Market Update 01/15/2016

We hope everyone had a wonderful holiday season! The stock market is definitely experiencing post-holiday blues as the start to the New Year has been quite a rocky one. The S&P 500 has given up about 8% (including today's trading) and is again in "correction" territory, or 10% off its most recent peak in November.

As we cautioned back in December, we expected stock market volatility to continue due to uncertainty over global growth, stemming from doubts about China's economy and the prolonged downturn within energy and commodities markets. In preparation, we turned more defensive in the second half of last year by reducing our exposure to sectors where we perceived there to be an elevated level of risk, and additionally by raising cash. We minimized our exposure to high yield bonds, small cap stocks and dramatically reduced our exposure to the commodities sector. Each of these asset classes have significantly underperformed the broader equity and fixed income markets over that time period.

During the fourth quarter we also chose to stay away from several highly publicized momentum stocks which we felt were overpriced (despite significant growth prospects). While revenue and earnings growth are key elements in our fundamental analysis, equally important is the price paid for this growth. This decision has paid off thus far in January as these have fallen much more than the market, which is consistent with historical experience. Overall, we now have less exposure to equities than we did six months ago, but the key was to establish this position prior to the recent volatility so that we have the resources available to capitalize on emotional selling and enter core long-term holdings at more attractive prices. These decisions were consistent with one of our primary goals in investing: the preservation of capital.

The China Question

China is the world's second largest economy and one of its fastest growing, so a slowdown there is bound to be impactful on the rest of the world. However, we still believe the Chinese government will do everything in its power in an attempt to orchestrate a "soft landing." While China has multiple resources to address a slowdown in growth, the events over the past six months have added an element of uncertainty regarding their ability to achieve their long-term goals. As a supplier of raw materials to China, other emerging markets, like Latin America for instance, are feeling much of the pain and for the most part are in full blown recession.

Stateside, we believe the China contagion will be more contained. The most direct way the U.S. economy is affected by an economic downturn in China would be through weaker exports. While they run in the billions of dollars, US exports to China account for about 7% of total US exports, according to Moody's Analytics. In Europe, the figure is higher, particularly in Germany, where by some estimates China accounted for about 9% of total exports.

Oil prices

We can point to many culprits behind the staggering slide in oil prices. A shale oil boom in the U.S. and Saudi Arabia's determination to keep pumping to maintain market share have made the world awash in oil. On the demand side, China's slowdown certainly has been another major contributing factor. Add to that the dollar's appreciation and you pretty much had a recipe for disaster.

Predicting the direction of oil prices is even less useful than forecasting the weather, but we think it's fair to say that some stabilization over the next six to nine months could occur as production cuts lead to a bottom. Any weakening in the U.S. dollar could also accelerate the stabilization process.

The Good News

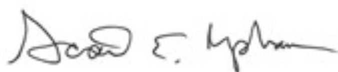
In spite of these two major headwinds, economic growth in the developed world, namely the US, Europe and Japan, has shown some resiliency. In the U.S., while the manufacturing sector is most impacted by the slowdown in China and other export markets, the consumer has still been spending. We see positive catalysts in both Europe and Japan as their respective central banks continue to pursue policies to stimulate economic growth, and they are producing encouraging results.

The Opportunity

While stock market corrections are never fun, the volatility they bring is not necessarily a bad thing. Indeed, it provides us with opportunities to buy high quality companies on sale. These include companies that not only are the blue chips of today, but could also be the blue chips of tomorrow. They are characterized by having exceptional brands and resilient business models, but they are now trading at more attractive valuations. Establishing a position at more compelling prices improves our opportunity to achieve better returns over the long term.

Meeting your longer term goals continues to be our focus, and maintaining the appropriate exposure to equities given your tolerance for risk is essential to accomplishing that. To that end, we are reaching out to you to check in and revisit your risk exposure and the role it plays in achieving your long-term goals. In the meantime, if you have any questions or concerns, please don't hesitate to contact us.

With warm regards,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